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From Regulation to Deregulation: The Diminishing Role of the Small Consumer within the Natural Gas Industry

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FROM REGULATION TO DEREGULATION: THE DIMINISHING ROLE OF THE SMALL CONSUMER WITHIN THE NATURAL GAS INDUSTRY*

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I. INTRODUCTION

Since 1938, the federal government has regulated the natural gas industry. Today, the Federal Energy Regulatory Commission ("FERC"), the successor to the Federal Power Commission ("FPC" or "Commission"), while ostensibly still required by Congressional mandate to regulate the natural gas industry, has charted a precise course

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toward deregulation. Its newly issued Order No. 636,¹ and on rehearing Orders No. 636-A and 636-B, maps out the future of the natural gas industry. Through this Order, the FERC intends to abandon the old regulatory system in favor of the brave new world of deregulation and free competition. To reach this objective, Order No. 636 proposes a complete overhaul of the industry through the individual restructuring of interstate pipeline services. The central feature of these new arrangements will be the unbundling of sales and transportation services, thereby giving all participants in the gas industry equal access to quality service.

The decision to deregulate the natural gas industry was not made overnight. Since 1978, when Congress passed the Natural Gas Policy Act, the federal government has increasingly sought to enhance the influence of market forces, and conversely, to minimize the influence of regulatory forces. A product of political choice and economic reality, the decade-and-a-half-old experiment is now a permanent fixture of United States energy policy. The complete deregulation of the natural gas industry, however, has not come cheap. With billions of dollars potentially at stake, parties which rely upon and are dependent upon the old regulatory apparatus do so at their own peril. Nowhere is this assertion better demonstrated than in regard to small customers and their place in the post-636 natural gas market.

Natural gas regulation emerged over a half century ago primarily to protect the individual customer from the predatory practices of monopolistic pipelines. Today, although the potential for monopolistic exploitation has largely dissipated, the precarious position of residential consumers has not. Although the current watchwords of open access and unbundling may have considerable appeal, it remains to be seen whether the small players in the industry will be able to share in its anticipated rewards. Despite FERC assertions to the contrary, the substantive provisions of the restructuring rules do not appear to contain sufficient protections for the small consumer. This development signals a disturbing trend in an industry which, while still paying lip service to the groups it was originally charged to protect, has drifted

1. Order No. 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation and Regulation of Natural Gas Pipelines After Partial Well-head Decontrol, 57 Fed. Reg. 13,267 (1992), III F.E.R.C. Stats. & Regs. ¶ 30,939 (1992), *order on reh'g*, Order No. 636-A, 57 Fed. Reg. 36,128 (1992), III F.E.R.C. Stats. & Regs. ¶ 30,950 (1992), *reh'g denied*, Order No. 636-B, 57 Fed. Reg. 57,911 (1992), 61 F.E.R.C. ¶ 61,272 (1992), *appeal pending*, Atlanta Gas Light Co. v. FERC (D.C. Cir.).

further and further away from its historic mandate. Pipelines now operate under fewer consumer-oriented regulatory constraints than ever before and, hence, do not currently have any incentives to contain costs. As the "636" series of rules are inevitably challenged, both at the administrative level and at the federal court level, the effects of unbundled service on captive customers will undoubtedly be one of the most hotly contested issues.²

II. THE STRUCTURE OF THE NATURAL GAS INDUSTRY

The historic and current role of the individual consumer cannot be evaluated without an examination of the natural gas industry's organizational scheme. The industry is composed of the producers of the commodity, the pipeline companies who transport it, the local distribution companies who make it available to the public, and of course, the consumer who uses the service at the end-link in the industry chain. For over fifty years, these entities have produced, transported, sold, distributed, and consumed the nation's gas supplies under a comprehensive regulatory umbrella. Because these segments are all bound together, historically as well as economically, by the matrix of both federal and state regulation, any policy decision affecting one necessarily affects the others.

The initial players in the natural gas market, the producers, or the "wellhead" as they are collectively termed, have traditionally explored and drilled for the resource, and have subsequently sold it to the pipeline companies.³ Although they were not originally subject to regulation, the Supreme Court ruled in 1954, that wellhead prices fell within

2. At press time, the Commission's pipeline restructuring rule is currently awaiting review in the D.C. Circuit which is now in the process of consolidating the voluminous number of appeals into one hearing. The first of the more than 200 petitions for review was filed on August 13, 1992. After the Eleventh Circuit was chosen as the circuit court in which to consolidate all of the petitions, the Exxon corporation moved on October 2, 1992 for a change of venue to the D.C. Circuit. After sixteen months elapsed, the Eleventh Circuit finally granted Exxon's motion (and that of the Process Gas Consumer Group) on February 15, 1994, for a change in venue to the D.C. Circuit. The appeal of Order No. 636 is now subsumed under *Atlanta Gas Light Co. v. FERC*. As yet, no docket number has been assigned as the D.C. Circuit is still sifting through the appeals. See *Eleventh Circuit Grants Motions For Change of Venue and Transfers Over 100 Petitions to Review Order No. 636 to D.C. Circuit*, FOSTER NAT. GAS REP., No. 1967, (1994), at 12-13; Daniel Drosdoff, *Court Delays, Passage of Time Hurt Challenges to Order 636*, 10 NAT. GAS WEEK, Mar. 7, 1994, at 5-6.

3. See *Tenneco Gas v. FERC*, 969 F.2d 1187, 1193 (D.C. Cir. 1992); CHARLES F. PHILLIPS, JR., *THE REGULATION OF PUBLIC UTILITIES* 696 (1993).

the statutory jurisdiction of the FPC, rejecting the argument that well-head pricing was exclusively a state concern.⁴ Today, the producers' industry operate under a minimal degree of command and control. Just over four years ago, Congress effectively reversed the Supreme Court's holding with the passage of the Natural Gas Wellhead Decontrol Act of 1989.⁵

Once the gas leaves the wellhead, the pipelines intercept it and transport it from those geographic areas rich in the natural resource to those areas without it. The pipelines purchase gas either from the producers themselves or from other pipelines. The classic "middle-man" within the industry as well as the segment subject to the most regulation, the pipelines have historically acted as merchants.⁶ They buy the gas with the intention of reselling it, and transport it over large areas to customers at the other end of the pipeline. Yet, with deregulatory impulses sweeping through the industry and culminating in Order No. 636, the pipeline owners have increasingly been forced to forsake their traditional merchant role, and to operate almost exclusively as common carrier transporters.

The third component within the natural gas mix are the local distribution companies ("LDCs"). The LDCs purchase gas from the pipelines and resell it to customers within their given geographic area, primarily large industrial users or residential consumers. Operating primarily within state boundaries, and thus exempt from most federal regulation, LDCs have answered to state utility commissions. Historically, state jurisdiction attaches at the point where the gas leaves the interstate pipeline facilities and enters the smaller LDC pipelines.⁷

Traditional natural gas regulation sought to strike a balance between all of the various segments of the industry, with the end-user, the consumers, constituting the favored interest. Over time, competition has replaced the consumer as the preference underlying the federal government's approach toward managing the natural gas

4. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 677 (1954), *reh'g denied*, 348 U.S. 851 (1954).

5. Pub. L. No. 101-60, 103 Stat. 157 (1989) (repealing Title I of the Natural Gas Policy Act of 1978) (codified at 15 U.S.C. §§ 3311-33 (1988)).

6. Although interstate pipelines have traditionally been federally regulated, intrastate pipelines have predominantly been subject to state and local regulations. *See Oklahoma v. FERC*, 661 F.2d 832, 834 (10th Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982). Although the Tenth Circuit acknowledged the federal-state jurisdictional boundaries over natural gas, it affirmed the district court's decision upholding the constitutionality of the Natural Gas Policy Act imposing price controls on wholly intrastate gas. *Id.*

7. Frank R. Lindh, *Federal Preemption of State Regulation in the Field of Electricity and Natural Gas: A Supreme Court Chronicle*, 10 *ENERGY L.J.* 277, 306-09 (1989).

industry. Competitive developments, while they may produce an optimal result in time, have thus far been problematic. Having patterned their economic behavior and expectations around decades of regulation and protection, residential consumers have now had to readjust under deregulation. They are arguably far more constrained in their economic behavior and more limited in resources than are producers, pipelines, or LDCs. This argument is not to suggest that a fully competitive natural gas industry is not a desirable outcome. If someday the free market for natural gas can provide ready supply at low prices, then all will benefit. Before that point can be reached, however, the problems facing small customers in the wake of post-636 transition must be resolved.

III. CONSUMER PROTECTION: THE NATURAL GAS ACT OF 1938

The natural gas industry entered the world of regulation with the Natural Gas Act ("NGA") in 1938.⁸ Its passage transformed the industry from an object of largely provincial concern to one of great national import. The Act transferred the authority to make major decisions regarding the transportation and sale of the commodity from state and local governments to federal regulators. Purely intrastate transactions were not to be affected by the Act while interstate transactions were.⁹

Congress empowered the Federal Power Commission to assert jurisdiction over three major activities of the natural gas industry. The primary category of regulation was the sale of gas. All interstate sales of gas for resale had to be "just and reasonable."¹⁰ Moreover, the FPC had to authorize every sale by granting a certificate of public convenience and necessity.¹¹ The second area of regulation was the

8. Natural Gas Act of 1938, ch. 556, 52 Stat. 821 (1938) (codified at 15 U.S.C. §§ 717-717w (1988)).

9. The NGA provided:

The provisions of this [Act] shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

Natural Gas Act of 1938, 15 U.S.C. § 717(b) (1988).

10. "Just and Reasonable" is the current standard of review for the sale of natural gas under the NGA. 15 U.S.C. § 717c(a) (1988).

11. This provision is still in force today. A certificate will be granted only after an application is filed with the FERC which is then open for review and a hearing. 15 U.S.C. § 717f(c)(1)(A)-(B) (1988).

transportation of such gas. Prior to any interstate transportation, a pipeline also had to obtain a public convenience and necessity certificate.¹² Finally, the FPC regulated abandonment. Once a facility or pipeline service became subject to its jurisdiction, it could not be discontinued without FPC approval.¹³

Preserving the interests of small residential users was the impetus behind the passage of the NGA. Congress was concerned that the monopolistic characteristics of the natural gas industry would harm the small residential users. In 1935, three years before the NGA's passage, the Federal Trade Commission compiled a study concluding that the natural gas pipeline industry was indeed a natural monopoly.¹⁴ Wishing to minimize any adverse effects from potentially anticompetitive practices, Congress drafted the NGA with the clear intention of protecting the individual consumer. Its main focus was to guarantee the consumer a reliable source of natural gas at a price determined to be reasonable.¹⁵

To accomplish this objective, Congress had to assure interstate pipeline companies that any investment in transportation and sales could be recovered. This assurance raised two concerns. First, the pipelines would have to have enough gas to meet consumer demand in order to cover their construction costs. Second, they had to have a predetermined market for their gas sales.¹⁶

The FPC developed a three part strategy to balance the pipelines' interest in sharing the risk involved in transporting and selling natural gas, against the consumers' concerns of not having to pay excessive prices for reliable service.¹⁷ The first part of this strategy permitted

12. 15 U.S.C. § 717f(c)(1)(a) (1988).

13. 15 U.S.C. § 717(b) (1988).

14. At the time, only four large interstate pipeline companies were responsible for the sale and transportation to the LDCs within their given geographic area. In addition, they resembled natural monopolies because they were also the exclusive purchasers of gas from the production wellheads in their area. Noting that the industry contained some of the textbook features of a monopoly/monopsony (for instance, abnormally high prices, considerable accumulation of wealth at the expense of producers and consumers, and insufficient availability of the pipeline service), the FTC recommended that the industry be regulated. Report of the FTC to the U.S. Senate, S. Doc. No. 92, 70th Cong., 1st Sess. 588-91 (1928); Richard J. Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 348 (1983).

15. See *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 611 (1944) ("The primary aim of [the Natural Gas Act] was to protect consumers against exploitation at the hands of natural gas companies.").

16. Charles Stalon & Reinier Lock, *State-Federal Relation in the Economic Regulation of Energy*, 7 YALE J. ON REG. 427, 479 (1990).

17. *Id.*

pipelines to achieve a monopoly over the sale of gas through the provision of a “bundled” service. A bundled service allowed a pipeline to provide transportation of gas only to parties who purchased from it. LDCs and large end-users who wished to buy directly from the wellhead could not force the pipeline to transport their gas. Because the cost of building their own pipeline link to the wellhead was prohibitive for such parties, LDCs and large end-users generally resigned themselves to accepting its bundled form.¹⁸

The second part of the strategy required each pipeline to contract with producers for a ready supply of gas before they would be able to either sell to a given market, or build a line to a new one. As the typical duration of such producer-pipeline supply contracts was twenty years, this requirement guaranteed LDCs and end-user customers an adequate and reliable gas supply.¹⁹

The third prong of the natural gas regulation strategy provided pipelines with a constant and stable level of demand for their services. The effects of public convenience and necessity certificates not only bound pipelines to a given market, they also bound the markets to a given pipeline.²⁰ Consequently, LDCs were obligated to enter into twenty year contracts with the pipelines. In other words, because LDCs were usually required by local and state regulations to sell gas to specific communities and end-users, pipeline supply was marketed for a captive demand.²¹

During the initial decades of this regulatory strategy, three distinct characteristics emerged within the natural gas industry. Predominantly, the transportation monopoly which pipelines enjoyed became a permanent feature of the industry and was increasingly extended to sales of gas in interstate markets.²² Second, within the wellhead-pipeline-LDC-burner-tip framework, the interstate pipeline acted as a middleman for the rest of the industry segments and thus, increasingly occupied a role of central importance within the entire industry.²³ Under this arrangement, producers, LDCs, and end-users did not have contact with one another. Any economic relationship which existed between them operated through the pipelines. Finally,

18. *Id.*

19. *Id.* at 479-80.

20. *Id.* at 480.

21. *Id.*

22. *Id.* at 480.

23. *Id.* at 481.

the risks of the industry were largely allocated to the end-user customers. Insulated from competitive pressures through devices such as certification requirements, bundled service monopolies, and virtual sole supplier control over their markets, pipelines earned a sizeable rate of return on their investments.²⁴ Because the downstream end-users were dependent upon the monopolistic pipelines for supply and pricing, they were unable to respond to fluctuations in sales or service.

In spite of its shortcomings, the NGA-created system seemed satisfactory for all concerned. Producers did not have to worry about pipeline buyers to whom they could unload their gas. Pipelines did not fear any attempts at "cream-skimming" their monopoly service by potential competitors, and LDCs and end-users were confident that they would not suffer any lags in their supply requirements, or disruptions in their service, respectively.

IV. PRODUCER PRICE REGULATION: THE *PHILLIPS* DECISION

The Supreme Court extended FPC jurisdiction to producers at the wellhead in *Phillips Petroleum v. Wisconsin*.²⁵ A producer who sold gas for resale in interstate commerce was held to fall within the regulatory ambit of the NGA.²⁶ For the first time, producers became subject to FPC regulation. The result in *Phillips* was not received favorably. The widespread political consensus which had initially supported regulatory control of the natural gas industry began to dissipate once the FPC tried to regulate producer prices.²⁷ Resentful of what they perceived as arbitrary encroachments upon their profit margins, producers began closing ranks against both the regulators and the consumer interests which government intervention was sworn to protect.

A second and more serious consequence of the *Phillips* mandate

24. Martin Kirkwood, Comment, *Distributor Bypass in the Deregulated Natural Gas Industry - Are Consumers Being Left in the Cold?*, 39 CATH. U.L. REV. 1157, 1173 n.111 (1990).

25. 347 U.S. 672 (1954), *reh'g denied*, 348 U.S. 851 (1954).

26. Once again, the Court noted that consumer protection was the primary motivation behind the Natural Gas Act. Accordingly, the Court held, "[R]egulation of the sales in interstate commerce for resale made by a so-called independent natural gas producer is not essentially different from regulation of such sales when made by an affiliate of an interstate pipeline company. In both cases, the rates charged may have a direct and substantial effect on the price paid by the ultimate consumers. *Protection of consumers against exploitation at the hands of natural-gas companies was the primary aim of the Natural-Gas Act.*" *Id.* at 685 (emphasis added).

27. Stalon and Lock, *supra* note 16, at 483.

was the increasing division of the industry into interstate and intrastate markets.²⁸ In an effort to set the individual rates of every independent producer, the FPC created an impossible caseload for itself as each proceeding was excruciatingly long and difficult to resolve. To better perform its task of wellhead price regulation, in 1960 the FPC developed the system of "vintaging."²⁹ Vintaging allowed the Commission to regulate producer rates by geographic area, thereby obviating the need to hold case-by-case rate proceedings.³⁰

One factor affecting rates under the vintaging system was whether the gas was "old" or "new." "Old" gas, or gas that was already discovered and flowing, was subject to artificially low price ceilings. "New" gas, gas which had not yet been discovered and thus was not available for production, was allowed a higher price limit to encourage the exploration of untapped reserves.³¹ Therefore, vintaging induced the established producers (who had mostly "old" gas to sell) to confine their gas to the intrastate market which was not subject to FPC authority so they could charge a higher rate for "old" gas.³² Pipeline customers also encouraged producers to focus their attention intrastate by refusing to pay for anything other than the cheaper old gas.³³

Certification of pipeline construction and services also became more complex after wellhead controls were adopted. The additional responsibility of regulating wellhead prices as well as that of "old" gas forced the Commission to spend more time scrutinizing pipeline certificates. The FPC was especially concerned that low-price old gas would not be made available on the interstate market and would therefore jeopardize the overall interstate gas supply. Forced to prioritize end-users in time of shortage, the FPC had to juggle all of the purchasing segments of the industry, the pipelines, the LDCs, the end-user customers, in a plan which contributed to the growing complexity

28. *Id.* at 483-84.

29. Statement of General Policy, No. 81-1, 24 F.P.C. 818 (1960).

30. Area Rate Proceeding No. AR 61-1, 24 F.P.C. 1121, 1124 (1960).

31. Statement of General Policy, *supra* note 29; Permian Basin Area Rate Cases, 390 U.S. 747, 759-60 (1968) (affirming the geographic method of regulating wellhead rates).

32. Stalon and Lock, *supra* note 16, at 483-84.

33. This practice reached a critical point during the 1970's when the OPEC oil shocks caused a corresponding rise in unregulated intrastate gas prices. At the same time, the price of regulated interstate gas stayed at regulated levels. Inevitably, a surplus developed on the intrastate market because buyers were unwilling to pay market-determined prices, and a shortage developed on the interstate market because of the artificially low prices. Stalon & Lock, *supra* note 16, at 483-84.

of the industry.³⁴

Critics noticed the increasingly balkanized nature of the industry. The main culprit was the FPC's attempts at regulating wellhead prices through vintaging, or "area rate" regulation. Only two years after the *Permian Basin Area Rate Cases*, the Fifth Circuit approved an area rate proceeding with explicit reservation. The Court expressed its concerns as to whether such regulations could help produce an adequate gas supply.³⁵ Despite abandoning this form of regulation in favor of other forms of producer regulation, the Commission was largely unsuccessful in maintaining a reliable interstate natural gas supply.³⁶

The possibility of shortage in the interstate natural gas market, while always threatening, became a harsh reality during the mid-1970's as division between the interstate market and the intrastate market grew. The OPEC oil embargo of 1972-73 and record-cold winters during the latter half of the decade produced a sharp rise in the price for unregulated natural gas. These events combined with the producers' disincentive to dedicate gas to the interstate regulated market created problems on all fronts. As feared, the intrastate market had a surplus of high priced natural gas, and the interstate market had a shortage of the artificially low-priced gas. As the discrepancy in cost widened between the "old" gas and "new" gas, the interstate market increasingly encouraged consumption and discouraged conservation at a time when macroeconomic conditions advised against it. Consequently, the national interstate supply of natural gas decreased, thereby jeopardizing the central caveat of the Natural Gas Act: consumer access to cheap gas.³⁷

V. THE BEGINNING OF DEREGULATION: THE NATURAL GAS POLICY ACT OF 1978

Congress sought to address these problems with the passage of

34. David Crump, *Natural Gas Price Escalation Clauses: A Legal and Economic Analysis*, 70 MINN. L. REV. 61, 72 (1985).

35. The Fifth Circuit termed the Commission's attempt at ensuring an adequate natural gas supply as merely "whistling in the dark." *Southern La. Area Rate Cases v. FPC*, 428 F.2d 407, 444 (5th Cir. 1970), *cert. denied*, 400 U.S. 950 (1970).

36. In 1974, the Commission eschewed area rate regulation altogether and implemented national price ceilings for different types of gas. *See* Just and Reasonable National Rates for Sales of Natural Gas, 51 F.P.C. 2212, 2215 (1974).

37. Section 1(a) of the Natural Gas Act expressly provides "that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest. . . ." 15 U.S.C. § 717(a) (1988). A nationwide shortage of natural gas would certainly be considered counter to the public interest.

the Natural Gas Policy Act of 1978 ("NGPA").³⁸ The most significant aspect of the NGPA was that it substantially loosened regulation of wellhead prices in order to neutralize the debilitating effects of the dual interstate/intrastate system.³⁹ Dividing gas supplies into three major categories, each with its own pricing formula, the Act sought to implement a policy of phased deregulation. "High-cost" gas, which was most expensive to explore and drill for, was deregulated immediately. "New" gas was subject to a ceiling which was to be increased higher than the rate of inflation until complete deregulation on January 1, 1985. "Old" gas, the cheapest variety, had no set date for deregulation and was tied to a price ceiling equivalent to the rate of inflation.⁴⁰

The NGPA represented a major policy shift by Washington regarding the regulation of natural gas. By lifting the price ceilings and other restrictions which tended to discourage production and balkanize the gas markets, Congress hoped to achieve through deregulation what had previously failed through regulation: ensuring the American consumer a ready supply of natural gas. In enacting multiple price categories for different types of gas, the NGPA encouraged producers to supply more gas. At the same time, residential consumers were protected because the more plentiful "old" gas was still subject to strong regulatory controls.⁴¹ Yet, the multiple price categories also had the effect of signaling to the industry that natural gas regulation would not last forever. Indeed, by permitting some types of gas to be deregulated, whether immediately, or by the end of 1984, the NGPA conceded that consumers would eventually have to depend upon the market, rather than the federal government, for protection against high rates.

In addition to deregulating wellhead prices, the NGPA also ended the historic pipeline monopoly as well. Under section 311 of the NGPA, Congress encouraged the separation of the dual merchant/transporter roles of the pipelines to better effectuate the integration

38. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (1978) (codified as amended at 15 U.S.C. §§ 3301-3432 (1988)).

39. The FERC lifted price controls on producers in order "to give market forces a more significant role in determining the supply, the demand, and the price of natural gas. . ." *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd. of Miss.*, 474 U.S. 409, 422 (1986).

40. Congress further implemented this policy through the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157 (1989) (codified as amended at 15 U.S.C. § 3301 (1988)) (eliminating all wellhead price controls by January 1, 1993).

41. JOSEPH P. TOMAIN ET AL., *ENERGY LAW AND POLICY* 302 (1989).

of the intrastate and interstate markets.⁴² The FERC could authorize any pipeline to transport gas which was not its own to sell. As a result, some interstate pipeline customers began purchasing gas directly from producers or other sellers and then using the pipelines solely to provide transportation, or "unbundled" service. Thus, pipelines would experience a loss of market power as their monopoly over transportation no longer meant a monopoly over sales. From the consumer standpoint, section 311 indicated that unbundling would be path that the industry would eventually follow. Subsequent Commission efforts to promote the unbundling process served to erase any doubts regarding this trend.

VI. THE TAKE-OR-PAY DILEMMA

Pipelines were the first to bear the brunt of deregulation. The deregulation of prices at the wellhead and the unbundling of the merchant and transportation functions of the interstate pipelines was not the panacea which Congress envisioned. To be sure, such competitive incentives boosted the supply and production of natural gas, and therefore, reduced the inherent friction between the interstate and intrastate markets. As supplies grew and the price of gas fell,⁴³ pipelines were forced to bear a disproportionate share of the volume and price risks of the deregulated commodity.

The problems the interstate pipelines faced after the promulgation of the NGPA were largely from the long-term contracts they had with producers. During the 1960's and 70's when a reliable supply of natural gas at a reasonable price was an uncertainty, the pipelines sought to safeguard their ability to meet their minimum public service obligations as well as their projected future sales. Consequently, they entered into contracts which permitted large-volume purchases of gas

42. 15 U.S.C. § 3371 (1988). The relevant provisions of §§ 311(a)(1)(A), (a)(2)(A), and (b)(1) of the NGPA which address the unbundling of interstate pipeline service read respectively:

The Commission may, by rule or order, authorize any interstate pipeline to transport natural gas on behalf of (i) any intrastate pipeline; and (ii) any local distribution company. The Commission may, by rule or order, authorize any intrastate pipeline to transport natural gas on behalf of (i) any intrastate pipeline; and (ii) any local distribution company served by any interstate pipeline. The Commission may, by rule or order, authorize any intrastate pipeline to sell natural gas to (i) any interstate pipeline; and (ii) any local distribution company served by any interstate pipeline.

Id.

43. Traditionally, producers bore such risks. The "volume risk" was "the risk that a pipeline will in the future choose not to purchase any of the gas the producer has dedicated exclusively to the pipeline." The "price risk" denoted "the risk that the future market price of gas will substantially exceed the price stated in the contract." Pierce, *supra* note 14, at 355.

in exchange for being subject to take-or-pay⁴⁴ and escalation clause⁴⁵ liability. Under the old regulatory system, such contractual terms did not appear onerous because the price of gas was set at relatively low levels. Pipelines could rely on the fact that any rise in natural gas prices would be predictably small, and any lost sales to LDCs could be absorbed rather easily. If prices were allowed to fluctuate with market conditions, however, such losses could potentially be substantial.

The pipelines' contractual liability first became a critical problem during the 1981-82 recession. Instead of the shortages which characterized the industry during the previous decade, NGPA deregulation created a surplus bubble as producers and pipelines encountered fewer constraints in dedicating gas to the interstate markets.⁴⁶ In 1982, this bubble grew larger. The economic downturn caused a drop in the demand for natural gas as larger numbers of end-users stepped up conservation efforts. The price of natural gas fell accordingly, but the reduction was almost solely limited to the intrastate market and the emerging spot market.⁴⁷ The interstate pipelines were unable to respond to these market conditions by lowering prices because they were still contractually bound to pay higher prices to producers. Purchasing gas at the wellhead at the contractual price, and trying to resell the same to LDC and end-user customers who were only willing to pay the lower market price for the gas, "squeezed" the pipelines.⁴⁸

Prior to the NGPA, the interstate pipelines could have dictated their customers' purchasing decisions by refusing to transport their gas unless the pipelines were the ones who sold it. Under the new system of "unbundled" service however, pipelines were no longer able to exert such control. Pursuant to the NGPA, large industrial end-users who had "switchable" capacity could change to an alternative fuel if they were dissatisfied with pipeline prices.⁴⁹ Similarly, intrastate

44. A take-or-pay clause obligates a pipeline to purchase a certain amount of gas at a specified price and pay for the gas even if it is not taken. *See Transcontinental Gas Pipeline Corp. v. State Oil and Gas Bd. of Miss.*, 474 U.S. 409, 412 (1986).

45. An escalation clause requires a pipeline to pay an increasing amount for gas as its contract price is tied to changes in both the nominal and real market values of the gas. *See Pierce*, *supra* note 14, at 355.

46. Stalon & Lock, *supra* note 16, at 487.

47. The "spot market" refers to purchases and sales of natural gas on a short-term basis. These contracts have traditionally been for lower prices than long-term arrangements because the producer concedes to the pipeline the right to discontinue its spot sales when the long-term contract is completed. HOWARD R. WILLIAMS & CHARLES J. MEYERS, *MANUAL OF OIL & GAS TERMS*, 1180 (8th ed. 1991).

48. *See Crump*, *supra* note 34, at 62.

49. *See TOMAIN ET AL.*, *supra* note 41, at 310. In order to try to prevent these customers from switching fuels, the FERC instituted special marketing programs (SMPs) which allowed

pipelines, who were now permitted to sell gas on the interstate market, could require their interstate counterparts to transport their gas pursuant to section 311. Whether bound by a take-or-pay contract or an escalation contract, an interstate pipeline faced financial disaster unless it could renegotiate the terms to which it agreed under regulated conditions.⁵⁰

Efforts by interstate pipelines to acquire relief for their potentially huge liability were not received favorably by the producers at the wellhead.⁵¹ For one thing, the producers believed that they were performing a service for the pipelines by agreeing to dedicate large volumes of gas to the interstate market at a time of comprehensive regulation and price controls. Presumably, they could have sold their gas for higher prices on the intrastate market just as easily.⁵² Secondly, and perhaps most importantly, producers maintained that the long-term contracts were risks because they were based upon both parties' good-faith expectations of future events. Merely because the industry had been deregulated in the interim and the risks which the pipelines bore were aggravated accordingly, was not a sufficient reason for their abrogation.⁵³ Many producers thought it ironic that the pipelines, who were insistent on observing contractual commitments when the producers were selling gas at artificially low prices, were now trying to avoid them.⁵⁴

VII. ORDER NO. 436: THE OPEN ACCESS REGIME

The FERC responded to the charge of the NGPA by adopting a formal policy to promote competition. The goal of this policy was to alleviate the conditions which were strangling the pipelines.⁵⁵ As a

pipelines to sell them cheaper gas. This provision, however, did not help the pipelines in covering their fixed, operating, or take-or-pay costs. Thus, small customers who were unable to switch fuels bore a disproportionate share of the pipelines' cost burden. These SMPs were struck down as unduly discriminatory. *Maryland People's Counsel v. FERC*, 761 F.2d 780 (D.C. Cir. 1985).

50. See *Trunkline Gas Co.*, 58 F.E.R.C. ¶ 61,240 (1992) (stating that the interstate pipeline faced more than \$370 million in take-or-pay liability); see also *United's Plan to Wipe Out its Take-or-Pay Liability was Accepted*, INSIDE FERC, Aug. 26, 1991, at 10 (finding that United Gas had accrued more than \$857.8 million in take-or-pay liability).

51. Stuart Magowan, *Nobody Likes the U.S. "Free" Market in Natural Gas*, ENERGY ECON., Dec. 1988, at 9.

52. Pierce, *supra* note 14, at 355.

53. Magowan, *supra* note 51, at 9.

54. *Id.*

55. See *Northern Natural Gas Co.*, 48 F.E.R.C. ¶ 61,232, at 61,828 (1989). The Commission noted:

Circumstances in the industry have changed by reasons including its own maturation,

result, Order No. 436,⁵⁶ which spells out this policy, made deregulation a permanent fixture of the natural gas industry. While ostensibly seeking to protect the interests of all concerned, the consumers' interests began to become less important within the natural gas regulatory scheme under the FERC's new policy. In short, as the FERC nudged the industry away from NGA-era regulations, it slowly shifted its focus away from the initial beneficiaries of these controls as well.

The hallmark of Order No. 436 was "open access" to interstate pipeline systems on a nondiscriminatory basis.⁵⁷ By permitting all users of gas; whether an intrastate pipeline, an LDC, or a large end-user; to employ interstate pipelines for transportation from any supplier, the Order redefined the future of the industry, as well as the place of residential consumers within it. The Commission sought to provide "open access" by explicitly targeting transportation, certification procedures, and billing mechanisms. In addressing transportation, the FERC took a further step toward the "unbundling" of the interstate pipeline monopoly by encouraging pipelines to act as common carriers of natural gas. Instead of only transporting gas which they themselves were reselling, pipelines could also transport on a non-discriminatory basis gas which was not theirs to sell.⁵⁸

Although the pipelines were not subject to Order No. 436, it provided a host of incentives for those pipelines which chose to comply. First, pipelines which agreed to act as common carriers were better

the Congressional decision to deregulate the pricing operations of the competitive well-head markets, the Commission's encouragement of open access to interstate pipelines' systems, the increased opportunities exhibited by industrial and commercial users of natural gas, and the varied approaches available to state commissions to regulate local transportation markets.

Id.

56. Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed.Reg. 42,408 (1985) (codified in scattered sections of 18 C.F.R.), *aff'd in part and vacated in part*, Associated Gas Distribs. v. FERC, 824 F.2d 981 (D.C. Cir. 1987) [hereinafter *AGD I*], *cert. denied*, Shell Offshore Inc. v. Associated Gas Distribs., 485 U.S. 1006 (1988), *on remand*, Order No. 500, 52 Fed.Reg. 30,334 (1987).

57. See *Northern Natural Gas Co.*, 48 F.E.R.C. at 61,828-29. The Commission observed that:

The goal of [current] policy is to provide incentives and opportunities that allow all shippers, industrial users as well as LDC and other parties, to benefit by access to commodity and transportation markets at price levels indicating market discipline. [B]enefits. . . include clear and diverse pressures and opportunities assuring the availability of gas services at [the] lowest reasonable costs.

Id.; see also *AGD I*, 824 F.2d at 993-94.

58. Previously, end-user customers were unable to purchase natural gas at the wellhead at prevailing market prices because interstate pipelines would not transport such gas if that gas would compete with their sales. See *AGD I*, 824 F.2d at 996.

able to gain entry into new downstream end-use markets because Order No. 436 simplified traditional section 7 (NGA) certification requirements. Instead of having to complete a complicated procedure showing the "convenience and necessity" for new services and facilities or for a transportation plan, pipelines were permitted to obtain pre-approved "blanket" certification if they agreed to provide nondiscriminatory access to whoever requested it.⁵⁹ The rationale behind lowering such barriers to entry was based on the premise that increased competition through open access sales and transportation would prove best for the industry and would enable pipelines to remain competitive.⁶⁰

Order No. 436 gave pipelines facing mounting take-or-pay liability the right to convert their sales obligations under their wellhead contracts to transportation entitlements from other suppliers.⁶¹ For example, if a pipeline customer was reluctant to pay the "take-or-pay" rate for gas, the pipeline could respond by offering to trade its sales service for its transportation service and apply it to its wellhead contract.⁶² Consequently, pipelines could lessen their obligations to some extent by agreeing to surrender their sales monopoly to the downstream market. Despite these efforts however, take-or-pay would continue to remain an irascible problem.⁶³

Order No. 436 permitted customers to purchase gas from any available supplier. Consequently, interstate pipelines and local distribution companies were confronted with the problem of "bypass." In

59. In exchange for benefitting from this expedited certification process, pipelines, in turn, assumed the entire risk of their investments. Order No. 436, 50 Fed. Reg. at 42,467.

60. *Id.* at 42,410.

61. *Id.* at 42,409.

62. 18 C.F.R. § 284.10 (1990).

63. *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 1044 (D.C. Cir. 1987). Upon judicial review, the Circuit of the District of Columbia upheld the primary provisions of the Order. It approved the shift toward favoring increased competition within the industry and let stand its common-carrier and blanket certification provisions. Yet, the court remanded for further proceedings because the Commission failed to fully address the pipeline's take-or-pay problems in connection with its new open access policy and failed to explain adequately its reasons for not doing so. Judge Williams expressed reservations that the FERC had not examined the possibility that Order No. 436 would enable more pipeline customers to buy cheaper gas directly from producers, thereby increasing the pipelines' take-or-pay exposure, and denying pipelines' necessary bargaining leverage in settling their take-or-pay liability with producers. *Id.* at 1020-30.

Although the Court concluded that the take-or-pay problem was "not enough to block necessary pro-competitive reforms," it did assert that the Commission's "seeming blindness to the possible impact of Order No. 436 on take-or-pay liability, and its tendency to elevate into affirmative benefits what are at best palliatives, seem impossible to square with the requirement of reasoned decision making." *Id.* at 1027, 1025.

the natural gas industry, bypass refers to "the development of specialized facilities that circumvent those facilities owned and operated by the [pipeline or the LDC]." ⁶⁴ In encouraging various segments of the industry to seek out alternative sources of natural gas, Order No. 436 placed the pipelines and LDCs in a tenuous position. Having based all of their business expectations and decisions upon having a reliable pool of customers, they both faced the prospect of having some of these customers "bypass" their facilities and obtain gas supplies elsewhere. Failure to replace lost customers with new ones would produce substantial losses. On a grander scale, such a result would harm the pipelines who were already saddled with contractual obligations, and would harm the LDCs who did not exhibit the monopolistic features or substantial economies of scale unique to the pipelines, and thus, could compete with the former only at a competitive disadvantage. ⁶⁵

In retrospect, the end-user customers were perhaps the most likely to be hurt the most by 436-induced bypass. Occupying the last link in the natural gas distribution chain, end-users purchase gas on the intrastate market from the local distribution companies. The fixed costs which the LDCs incur in purchasing gas from the regulated pipelines and then reselling it to end-users was typically spread throughout their customer base (subject of course to the applicable local regulations). Under the system of "open access" however, the larger industrial end-users opted to pursue more competitively priced alternatives. They either completely bypassed the LDC and constructed their own pipeline spurs to the pipeline, or they switched to an alternative energy source altogether. ⁶⁶ The loss of these large "switchable" customers ⁶⁷ left the "captive" ⁶⁸ users to absorb the LDC costs as reflected in the gas rate. ⁶⁹ Such users, usually smaller industrial units or individual residences, had neither the means nor the flexibility to bypass the

64. Paul MacAvoy et al., *Is Competitive Entry Free? Bypass and Partial Deregulation in Natural Gas Markets*, 6 YALE J. ON REG. 209, 211 (1989); bypass is defined more generically as the "entry of an alternate supply source in a partially deregulated market." *Id.*

65. Harry G. Broadman & Joseph P. Kalt, *How Natural is Monopoly? The Case of Bypass in Natural Gas Distribution Markets*, 6 YALE J. ON REG. 181, 184-85 (1989).

66. *Id.* at 186.

67. A "switchable" customer is one who has the means to change its energy source altogether. *Kansas Power & Light Comp. v. FERC*, 851 F.2d 1479, 1485 (D.C. Cir. 1988).

68. A "captive" customer, by contrast, does not possess such flexibility and thus is generally bound to the service. *Transcontinental Gas Pipe Line Corp. v. FERC*, 998 F.2d 1313, 1316 (5th Cir. 1993).

69. Broadman & Kalt, *supra* note 65, at 208.

LDC market.⁷⁰ Forced to receive gas from the LDCs, these remaining "captives" were exposed to large scale increases in their gas rates because they were the end-user least able to respond to price changes.⁷¹ Perhaps in the long run, these prices will ultimately decrease as a competitive natural gas market forces sellers to lower rates. In the mean time, however, consumers are sure to be harmed if rates increase with the lifting of regulatory controls.

VIII. LEADING UP TO 636: ORDER NOS. 500 & 528

Upon the D.C. Circuit's remand of Order No. 436, the Commission issued Order 500, an interim rule that instituted a policy of "equitable sharing" of take-or-pay liability across the natural gas industry among producers, pipelines, and LDC and end-user customers.⁷² The competitive provisions of Order No. 436, which provided the incentives for pipelines to assume open access status and to convert demand rights to transportation rights, were consistent with the D.C. Circuit's opinion and therefore retained.⁷³ The fulcrum of Order No. 500 was a policy concerning "acceptable passthrough mechanisms" by which pipelines in individual rate proceedings could recover take-or-pay buyout and buydown costs from their customers.⁷⁴ The Order al-

70. In one LDC bypass case, a large industrial end-user who wished to build six feet of pipeline faced an \$81,000 price tag. See *Northern Natural Gas Co.*, 46 F.E.R.C. ¶ 61,270 at 61,792 (1989).

71. This scenario is illustrated in vivid detail in *Panhandle E. Pipe Line Co.*, 38 F.E.R.C. ¶ 63,009, at 65,039 (1987), as an LDC incurred a \$51 million loss as a result of bypass and therefore had to allocate the costs to its remaining captive users.

72. Judge Williams wrote in *Associated Gas Distribs. v. FERC* that "[a]ll actors in the natural gas industry" other than "fuel switchable users, who . . . [could] employ the cheapest fuel competing with gas and thus . . . [could not] be induced to pay more than the current competitive [wellhead] price," were "candidates" for absorbing take-or-pay liabilities. 824 F.2d 981, 1021 (D.C. Cir. 1990) [hereinafter *AGD I*].

73. Order No. 500-H promulgated the Commission's final rule. III F.E.R.C. Stats. & Regs. ¶ 30,867 (1989) and Order No. 500-I, III F.E.R.C. Stats. & Regs. ¶ 30,880 (1990), substantially affirmed by the D.C. Circuit in *American Gas Assoc. v. FERC*, 912 F.2d 1496, 1520 (D.C. Cir. 1990), cert. denied, 498 U.S. 1084 (1991).

74. Because the take-or-pay issue was the primary stumbling block on the industry's route toward open access, the Commission reasoned it was only fair that all parties contribute to its resolution:

In many instances, pipeline take-or-pay obligations mounted because of reduced purchases by their customers due to purchases from alternative suppliers, fuel switching by industrial users due to lower fuel oil prices, reduced levels of economic activity, and conservation. The Commission recognizes that it is difficult to assign blame for the pipeline industry's take-or-pay problems. In brief, no one segment of the natural gas industry or particular circumstance appears wholly responsible for the pipelines' excess inventories of gas. As a result, all segments should shoulder some burden of resolving this problem.

Order No. 500, III F.E.R.C. Stats. & Regs. at 30,778-79.

lowed a pipeline to pass its prudently incurred buydown⁷⁵ and buyout⁷⁶ costs through to customers by means of a straight commodity surcharge on sales, the traditional means of recovering costs.⁷⁷ In promulgating Order No. 500, however, the Commission recognized that the open access pipelines' loss of sales customers might increase if the sales commodity rate rose substantially. Therefore, Order 500 also designed an alternative mechanism that permitted open access pipelines to share with their customers a portion of the costs incurred in settling their take-or-pay liability.⁷⁸

The D.C. Circuit also remanded Order No. 500 because of its purchase deficiency mechanism which, according to the Court, unnecessarily harmed the consumer.⁷⁹ Under this mechanism, the FERC allowed pipeline customers to pay charges according to past purchases which were less than what their pipeline contracts stipulated. The court held that attempting to pass on costs stemming from these cumulative purchase deficiencies violated the "filed rate doctrine."⁸⁰

In response, the FERC issued Order No. 528,⁸¹ allowing pipelines to develop new allocation methods to replace the deficiency allocation method that the D.C. Circuit struck down. Orders No. 528 and 528-A attempted to resolve the take-or-pay controversy without reversing any of the competitive advances that the Commission had promoted within the industry. These Orders also revealed the FERC's continued shift away from the interests of the customer. They provided that (1) costs should be spread as broadly as possible so that "all segments of the industry — pipelines, producers, LDCs, industrial end users

75. Buydown denotes a payment accompanying renegotiation of a contract which results in a reduced price term, an extension of delivery terms, a reduction in the total quantity to be purchased, or some combination thereof. WILLIAMS & MEYERS, *supra* note 47, at 135.

76. Buyout is a pipeline's payment to extinguish take-or-pay liabilities through a change in a long-term supply contract. *AGD I*, 824 F.2d at 1021.

77. 18 C.F.R. § 2.104(a) (1992).

78. Under this alternative mechanism, if the pipeline agreed to absorb between 25 percent and 50 percent of the buydown and buyout costs, it would be allowed to recover an equal amount by means of a direct charge to its sales customers, rather than attempting to collect such costs through the unpredictable commodity rate. The pipeline would then be allowed to attempt to recover the balance, if any, by means of a volumetric surcharge on both sales and transportation of gas. Order No. 500-H, III F.E.R.C. Stats. & Regs. ¶ 30,867, at 31,547-31,576 (1989).

79. *Associated Gas Distrib. v. FERC*, 893 F.2d 349, 355 (D.C. Cir. 1989), *cert. denied*, 498 U.S. 907 (1990) [hereinafter *AGD II*].

80. Under the "filed rate doctrine," a regulated entity is forbidden "to charge rates for its services other than those properly filed with the appropriate federal regulatory authority." *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 577 (1981).

81. Order No. 528, Order on Remand Staying Collection of Take-or-Pay Fixed Charges and Directing Filing of Revised Tariff Provisions, 53 F.E.R.C. ¶ 61,163 at 61,593 (1990), *reh'g granted in part and denied in part by*, Order No. 528-A, 54 F.E.R.C. ¶ 61,095 (1991), *appeal dismissed sub nom*; *Tennessee Gas Pipeline Co. v. FERC*, No. 91-1069 (D.C. Cir. 1992).

and other consumers — should contribute to funding the pipelines' take-or-pay costs;" (2) pipelines should absorb a significant proportion of the costs; (3) "captive sales customers — namely residential and small commercial gas users — should not bear a disproportionate share of take-or-pay costs;" and (4) pipelines and producers should abide by existing settlement agreements.⁸²

IX. THE NEW WORLD ORDER OF DEREGULATION: ORDER NO. 636

To date, the FERC continues the push towards deregulation with Order No. 636. The goal of Order No. 636 is a national gas market where a buyer can reach many sellers by meaningful access to the pipeline transportation grid.⁸³ A deregulated national market can be achieved only after all of the affected interstate pipelines restructure their services, and subsequently, resolve the inevitable disputes.⁸⁴

Among the aims of Order No. 636 is the preservation of unbundled pipeline services as originally promulgated in the NGPA, and the regime of open access, as introduced in the Order No. 436. Specifically, Order No. 636 requires pipelines to make their transportation and storage services available to any segment that desires them. To enable the pipelines to respond flexibly to these changes, the Order allows blanket sales certificates to be issued allowing pipelines to sell unbundled gas on a comparable basis with unregulated sellers. In addition, take-or-pay costs will continue to be recovered under Order

82. Order No. 528, 53 F.E.R.C. at 61,596-97.

83. On rehearing, the Commission summarized the rationale supporting Order No. 636:

In brief, the Commission found that the pre-Order No. 636 regulatory structure of the pipeline industry has, and will continue to have, a harmful impact on all segments of the natural gas industry and on the Nation. The Commission concluded that it was appropriate to take remedial action to improve the competitive structure of the natural gas industry to further the creation of an efficient national wellhead market for gas without adversely affecting the quality and reliability of the service provided by pipelines to their customers. The Commission believes that its action will result in a modern, viable, natural gas industry specifically fashioned to the needs of all gas consumers and the Nation for an adequate and reliable supply of clean and abundant natural gas at reasonable prices.

Order No. 636-A, III F.E.R.C. Stats. & Regs. ¶ 30,950 at 30,526, 57 Fed. Reg. 36,128, at 36,130 (1992).

84. As of September 29, 1993, the Commission approved the last of the 76 pipeline restructuring plans. In practical terms, all of the affected pipelines had to begin implementing Order No. 636 for the upcoming 1993-94 heating season which officially began on November 1, 1993. See, *With Order 636 Finish Line In Sight, Moler Frets About the Winter*, INSIDE FERC, Sept. 20, 1993, at 1.

No. 528 until a "market-based pricing mechanism" develops. To better effectuate Order 636's proposed regulatory scheme, the Commission intends to open restructuring proceedings for each pipeline and to invite the participation of industry parties. The proceedings will allow for negotiation of the market-based pricing mechanisms for unbundled pipeline sales, as well as for a full recovery of pipeline transition costs (including take-or-pay costs) arising from compliance with the Order.⁸⁵

Organizations representing small customers have responded quickly to Order No. 636.⁸⁶ Generally, their concerns reflect the belief that this segment of the industry is the least able to take advantage of the opportunities presented by open-access. This inherent inflexibility will not only deny captive customers the benefits of the new competitive marketplace, it will also shift onto them a disproportionate share of the transition burden.⁸⁷

85. *Pipelines' Wishes Fulfilled As Commission Issues Restructuring Rule*, INSIDE FERC, Apr. 13, 1992, at 1, 11-15.

86. Dózens of groups representing consumer interests filed petitions for rehearing of Order No. 636 within days after it was issued on April 8, 1992. In July, formal hearings were held by the House Energy and Power Subcommittee in which then FERC Chairman, Martin Allday, was forced to defend the rule against lawmakers who were concerned of its impact upon residential customers. See Thomas F. Berg, *Order 636 Heats Up House Hearing*, PUB. UTIL. FORT., Aug. 15, 1992, at 26. As of September 2, 1992, 40 parties had petitioned for rehearing of Order No. 636-A, which was issued in response to the criticisms leveled at 636. See *Petitions for Rehearing of Order No. 636-A Attack Several Modifications to Order No. 636 Rule*, FOSTER NAT. GAS REP. No. 1893, Sept. 10, 1992, at 22. More recently, Rep. Phillip P. Sharp (D-Ind.), the Chairman of the House Subcommittee on Energy & Power, wrote a letter to the Commission in which he took it to task for underestimating the impact of Order No. 636 upon captive customers. In the September 29, 1993 letter, Sharp borrowed heavily from a draft General Accounting Office study of the restructuring rule which criticized FERC for relying upon overly optimistic assumptions.

In sum, the Commission seems to have burdened captive customers, not helped them. It seems to have understated their burdens, and overstated their benefits. It seems to have taken pains to prevent burdens of favored industry segments, while not even discussing burdens on unfavored segments. It seems to have put the order's benefits on favored groups, and its burdens on unfavored groups.

Sharp Rains On Commission Parade Over Order 636 Implementation, INSIDE FERC, Oct. 4, 1993, at 1, 7.

87. The general outcry against the impact of Order No. 636 upon residential end-users cannot be dismissed as merely the product of "special interest" politics. In November of 1993, the independent General Accounting Office (GAO), in response to a June, 1992 request by the House Energy and Commerce Committee Chairman John D. Dingell, among others, released a final report of its analysis of the advantages and disadvantages of Order No. 636. The report expressed strong reservations about the alleged benefits which FERC claimed the restructuring rule would engender, especially where it concerned the small consumer. After considering the potential shift in fixed costs among pipeline customers, the probable transition costs incurred by the pipelines in implementing the new rule, as well as the estimated costs and benefits attributable to unbundling, the GAO observed that "[s]ignificant questions remain about the economic impacts of Order [No.] 636." GENERAL ACCOUNTING OFFICE, COSTS, BENEFITS AND CONCERNS RELATED TO FERC'S ORDER 636 16 (1993).

Several aspects of Order No. 636 raise troubling questions for those who represent small consumers. One such aspect concerns the increasing phenomenon of bypass. As large LDCs and industrial end-users continue to bypass with the FERC's encouragement, the cost of gas will inevitably increase for the captive customers.⁸⁸ Secondly, the restructuring rule does not appear to contain any mandatory requirements for the pipelines to contain the costs of their restructuring. To be sure, the Commission urges pipelines to try to accommodate the concerns of the captive customers, but accommodation is not necessary. Finally, consumer groups view Order No. 636 with alarm. Its provisions for transition cost recovery and straight fixed variable (SFV) rate design seem to undermine FERC's statutory duty to protect the natural gas consumer. One of the provisions of Order No. 636 which met with the most resistance allows pipelines to recover one hundred percent of their prudently incurred transition costs.⁸⁹ This provision undoubtedly represents the FERC's efforts to ease the impact which mandatory unbundling and open access will have on the individual pipelines. Nevertheless, the provision holds stark implications for the captive customer. Switchable pipeline customers, knowing that their cost of gas will necessarily increase as these transition costs are recovered, will surely bypass in favor of another supplier. With a smaller customer base left to absorb the full brunt of the restructuring transition, pipelines will have little choice but to pass through these costs to their remaining residential and other captive customers.⁹⁰

88. See *House Subcommittee Debates Economic Impact of Order No. 636 and State Prorationing Policies*, FOSTER NAT. GAS REP. No. 1884, July 9, 1992, at 1 (explaining that one pipeline, Texas Eastern, estimated that the increase in rates for its small customers would be 136%).

Recently, the chief executive officer of the Washington Gas Light Company, a local distribution company, announced that his company's fixed costs for fiscal year 1994, with Order No. 636 transition costs factored in, will be almost 40% higher than in fiscal year 1992 which was the period immediately prior to the implementation of pipeline restructuring. Order No. 636, in this executive's view, will "result in a potentially serious destabilization of the industry and higher gas costs for millions of residential and small commercial consumers." Marshall Yates, *GAO's Final Order-636 Report Restates Doubts About Benefits*, NAT. GAS WEEK, Nov. 15, 1993, at 1, 10.

89. See Order No. 636-A, III F.E.R.C. Stats. & Regs. ¶ 30,950, at 30,641 (1992). Transition costs include those borne by the pipeline companies to (1) modify existing gas supply contracts with producers to reflect the realities of the deregulated environment ("gas supply realignment costs"); (2) abandon equipment, such as storage facilities, which are no longer necessary because of Order No. 636 ("stranded costs"); (3) retire unpaid balances on gas supplies that the pipeline companies previously sold to their customers ("Account No. 191 balances") and (4) purchase required new equipment, such as gas metering stations and electronic bulletin boards that show available transportation capacity and other data ("new facility costs"). *Id.* at 30,457.

90. These costs are hardly insignificant. According to the GAO study, the pipeline companies' estimate of transition costs as of July 21, 1993, is about \$4.8 billion. The overall figure,

Issued on August 3, 1992, Order No. 636-A reaffirmed the FERC's commitment to 100 percent transition cost recovery.⁹¹ On rehearing, the Commission rejected small customer petitions which maintained that the planned recovery was patently unfair. The FERC declined to fashion a special exception for small customers on the grounds that steps had already been taken to "secure the benefits of restructuring and mitigate any adverse effects."⁹² Without providing any concrete assurances, it noted that "small customers should not be unduly burdened by transition costs on most pipeline systems."⁹³ The Commission did modify the initial rule somewhat by adding a requirement that pipelines must recover ten percent of their gas supply realignment costs (GSR) from their interruptible customers.⁹⁴ These same customers, however, are the same customers who can readily switch away from natural gas in favor of another energy source at any time. This provision will still leave captive customers responsible for 90 percent of pipeline transition costs. If it is a truthful assertion that overall transition costs will approach five billion dollars, surely a mere 10 percent "discount" for captive customers will hardly relieve them of their disproportionate burden. If the FERC is to continue to honor its half century commitment to the natural gas consumer, it must do more than simply announce lukewarm measures which appear to afford only modest protections at best.⁹⁵

Order No. 636 exposes the captive customer further because of

however, is probably higher; according to FERC, twenty-four pipelines have not yet reported their transition cost figures. GENERAL ACCOUNTING OFFICE, *supra* note 87, at 10.

91. See Order No. 636-A, III F.E.R.C. Stats. & Regs., at 30,641. Four months later the Commission issued Order 636-B which denied rehearing of Order No. 636-A and made no changes to the underlying provisions. Order No. 636-B, Order Denying Rehearing and Clarifying Order Nos. 636 and 636-A, 61 F.E.R.C. ¶ 61,272, at 61,988 (1992); see also *FERC Wraps Up Restructuring Rule, Turns Full Attention to Compliance*, INSIDE FERC, Nov. 30, 1992, at 1.

92. Order No. 636-A, III F.E.R.C. Stats. & Regs., at 30,655. Nothing precludes the pipelines from voluntarily absorbing some of the costs themselves, but they cannot be forced to do so. *Id.* at 30,649.

93. *Id.* at 30,641.

94. *Id.* at 30,643.

95. Not surprisingly, the GAO report was skeptical of the FERC's treatment of the residential gas user in its position on transition cost recovery. Although the GOA agreed with FERC's contention that much of the transition costs arising from implementing the new rule would have been incurred any way, it did acknowledge that permitting pipelines 100 percent transition cost recovery "raises questions about whether the companies will have a strong incentive to minimize such costs." GENERAL ACCOUNTING OFFICE, *supra* note 87, at 10, 16.

As it currently stands, the individual pipeline "rate" proceedings, as opposed to the already completed "restructuring" proceedings, loom large on the FERC horizon in the upcoming year. According to Chair Elizabeth Moler, of the "2nd-generation" Order No. 636 issues, the question of transition cost-recovery promises to be "the next major gas issue." INSIDE FERC, Sept. 20, 1993 at 9.

the straight fixed variable (SFV) rate design mechanism.⁹⁶ An SFV rate design includes all fixed costs relating to transportation in the reservation charge, so that pipelines will generally compete with one another with the same levels of fixed costs between them.⁹⁷ This "leveling of the playing field" is intended to make pipeline transportation service more responsive to market forces. Therefore, a given pipeline's competitive position will depend upon its own efficiencies in providing service, instead of upon the vagaries of fluctuating usage charges.⁹⁸ Consequently, captive residential consumers, the class of customer most dependent upon firm service, will bear a greater share of their pipeline supplier's fixed costs than before because those fixed costs will always be included in the reservation charge. The likely result will be a large shifting of costs from one group of customers to another. Interruptible customers, those best suited to react to market forces, will not be as affected by the SFV rate design as their rates have always been based upon usage, rather than reservation charges. Since the FERC intends to include fixed costs within the reservation charge, the firm captive customers, whose rates are determined by the reservation charge, will experience a subsequent increase in their rates.⁹⁹

Despite strident protests to the SFV proposal upon rehearing, the

96. Order No. 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 36,128 (1992).

97. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 57 Fed. Reg. 30,334, at 30,335 (1987). The SFV rate design replaces the modified fixed variable (MFV) approach. Under the latter design, pipelines were insulated from competition from alternative energy sources such as oil. Under these rates, pipelines' fixed costs were assigned to the reservation charge (or demand component of the overall rate). This served usually to lower their fixed costs included in the commodity component (or usage charge) relative to those in the demand charge. Under MFV, fixed costs included in the usage charge often differed from pipeline to pipeline; with SFV, these costs are constant. *Id.*

98. Order No. 636, 57 Fed. Reg. 36,128, 30,434 (1992). By contrast, under MFV, "producers in different fields that compete for market share via different pipelines will often have their competitive positions in that market affected by the amount of fixed costs in the pipelines' respective transportation usage charges and not by the producers' own costs and efficiencies in producing gas." *Id.*

99. The GAO report concluded that the change to SFV rate design could shift \$1.2 billion annually in fixed costs to those captive customers. In practical terms, such a shift would be reflected in an increase in firm customer's responsibility for the entire pipeline industry's \$11.4 billion if fixed costs from 65 to 76 percent. Individual customers, noted the GAO could expect to experience increases in their gas bills of up to nine percent. Non-residential end-users, by contrast, could expect a three to seven percent decrease. GENERAL ACCOUNTING OFFICE, *supra* note 87, at 6-7. See also Marshall Yates, *GAO's Final Order-636 Report Restates Doubts About Benefits*, NAT. GAS WEEK, Nov. 15, 1993, at 1, 10. Nevertheless, in a statement that can hardly provide much comfort to customers, the GAO did observe that the final cost-shift numbers "cannot be determined with any degree of precision until Order 636 has been implemented." GENERAL ACCOUNTING OFFICE, *supra* note 87, at 8.

Commission rejected petitioner requests to change its position. Conceding that reliance upon SFV, as opposed to MFV, would probably shift costs somewhat, it nevertheless maintained that it would also favor the lowest cost pipelines, and in time, such benefits would be passed along to the consumer in the form of lower rates.¹⁰⁰ The FERC did include a requirement in 636-A that parties to the restructuring proceedings must consider various rate-making techniques to help mitigate cost shifts onto customers.¹⁰¹ For example, in order to distribute the SFV cost responsibility among all customers, parties could adopt rates based upon seasonal contract quantities. Consequently, firm captive customers could reduce daily reservation quantities during off-peak seasons without jeopardizing such quantities during the peak times.¹⁰² If none of these suggested techniques prevents a dramatic cost shift, Order No. 636 provides for a four year mitigation plan. Under this provision, pipelines would be required to phase in cost shifts of greater than 10% for any class of customers for up to four years.¹⁰³

The main problem with the Commission's efforts to mitigate large-scale cost shifts created by the adoption of the SFV rate design lies in the fact that no particular rate-making technique is required. Rather, rates are to be determined by the pipeline and its customers in the individual rate-making proceedings.¹⁰⁴ Without a forceful FERC mandate expressly requiring the pipelines to adopt a specific methodology for mitigating SFV costs, it is difficult to envision how their customers can possibly bargain on an even footing. Despite reaffirming

100. In the Commission's view, the use of SFV would "over time force the evolution of a set of lowest-cost producers to yield lower prices and more abundant supplies to the benefit of all consumers of gas." Order No. 636-A, III F.E.R.C. Stats. & Regs. ¶ 30,950, at 30,593 (1992) (quoting H.R. Rep. No. 29, 101st Cong., 2d Sess., at 7 (1989)).

101. *Id.* at 30,599.

102. *Id.* at 30,604. Nevertheless, the Commission refused to consider mitigation on a case-by-case basis - as most petitioners were claiming different economic injuries - but rather, would only look at the impacts upon historic classes of customers. This refusal was just "because rates historically have been set by customer class and not for individual customers." *Id.*

103. *Id.* at 30,603-04.

104. If recent pipeline efforts to recover costs related to restructuring are any indication, opposition by consumers and the LDCs who serve them will be fierce indeed. For example, in late February, 1994, the Commission tentatively approved \$28.2 million in transition cost recovery for Natural Gas Pipeline Company, \$19 million for Northwest Pipeline, \$5.6 million for Mississippi River Transmission, and \$11 million for Texas Gas Transmission Corporation. These orders, and the rate increases which will invariably follow, will not take effect until all opposing parties exhaust their administrative and judicial remedies, or reach a settlement with the respective pipelines. Daniel Drosdoff, *FERC Gives Green Light*, NAT. GAS WEEK, Feb. 28, 1994, at 1, 14. Undoubtedly, these four pipelines and the 72 others which have implemented Order No. 636 on their systems will encounter stiff opposition as they seek to recover their transition costs.

its concern with customer costs under Order No. 636-A, the Commission has failed to provide these groups with sufficient leverage to prevent pipelines from refusing to mitigate.¹⁰⁵

In its own right, Order No. 636-A added two other modifications to the restructuring rule for the purpose of protecting small customers. One of these modifications attempts to help customers adjust to the post-636 transition. Blanket unbundled sales certificates would be issued unless pipelines offer to sell gas at traditional cost-based rates.¹⁰⁶ These rates would remain in force for one year after the pipeline's complete compliance with Order No. 636. This provision would serve to keep customer rates lower than market-based levels for a period of time allowing them an opportunity to find alternative supply arrangements, as they will no longer be bound to any one supplier.¹⁰⁷

Despite this grace period, it is questionable whether customers will be capable of finding alternative supply arrangements so easily. After years of having one LDC and one pipeline as their industry liaisons, in spite of having some extra time, captive customers will not have the necessary flexibility of their switchable counterparts. With their limited resources and less-than-imposing bargaining strength, this class will be hard-pressed to exact price terms more favorable than the traditional cost-based ones to which they have been accustomed.

On rehearing, the Commission added a second change to Order No. 636. Pipelines are required to permanently offer a one-part volumetric rate to small customers.¹⁰⁸ This rate, computed by the existing

105. The GAO study withheld judgment on the mitigation measures which the Commission proposed. It conceded that implementation of the restructuring rule would undoubtedly create higher costs for residential consumers, and otherwise acknowledged that it was "too early to determine how well the [mitigation] measures will work." GENERAL ACCOUNTING OFFICE, *supra* note 87, at 16.

From the consumer standpoint, there have been some encouraging signs. In a November 22, 1993, reply letter to Rep. Phillip P. Sharp (D-Ind.), the Chairman of the House Subcommittee on Energy & Power, who had himself written the Commission a letter raising questions about potential impacts upon consumers, Chair Moler indicated that the Commission may be open to exempting certain pipelines from the SFV rate design. Such exceptions, she observed, could be permitted where it could be demonstrated that such modifications would reduce cost shifts to firm customers. See Daniel Drosdoff, *Moler Tells Sharp to Chill Out, But LDC Chief Rips Order 636*, NAT. GAS WEEK, Nov. 29, 1993, at 1, 9.

106. *Id.* at 30,609.

107. As most pipelines did not meet the compliance requirements of Order No. 636 until after the 1992-93 heating season, small customers, for all intents and purposes, had two years with which to adjust their behavior. See *FERC Revamps Restructuring Rule to Ease Small-Customer Concerns*, INSIDE FERC, Aug. 3, 1992, 1 at 9.

108. Order No. 636-A, III F.E.R.C. Stats. & Regs. ¶ 30,950, at 30,545 (1992).

load factor, would allow the customer "to book capacity without paying a reservation charge."¹⁰⁹ In order to permit a wider class of customers to take advantage of this rate, pipelines would be encouraged to expand the definition of "small customer" to include those who transport up to 10,000 Mcf/day.¹¹⁰ The net effect of offering one-part volumetric service would be the insulation of small customers from some of the price increases sure to flow from full compliance with Order No. 636.

Although on its face, one-part volumetric service appears to provide adequate protection for small customers, it contains a limitation which dampens much of its cost-mitigating impact. This limitation provides that only pipelines which offered sales or firm transportation services on this same basis to small customers by May 18, 1992, the effective date of Order No. 636, are required to do so under the added provision.¹¹¹ If the Commission was serious about its obligation to the natural gas consumer, it arguably would not narrowly restrict the scope of this mitigating provision to only a select few.

X. CONCLUSION

Assuming the complete deregulation of the natural gas industry is all but inevitable, a tension has emerged between the FERC's mandate to protect the individual customer, and the need to guarantee a reliable supply of natural gas. Although its regulatory emphasis may have changed since 1938, the FERC's historic mission has not. No one disputes that a free, unregulated market for natural gas will benefit all concerned.¹¹² However, until that point is finally reached, the transition will be a painful one. The traditional linchpins of the industry, the interstate pipelines, have staggering costs, such as take-or-pay,

109. *INSIDE FERC*, *supra* note 107, at 1.

110. Order No. 636-A, III F.E.R.C. Stats. & Regs. at 30,545-46.

111. *Id.* at 30,545.

112. A dispute exists over just how much the benefits of Order No. 636 will exceed its costs. The GAO study criticized FERC's projections of net social benefits to be \$2-\$6 billion annually, and \$15-\$42 billion by the end of the century. The GAO faulted the projections for being based upon independent predictions of future increases in gas demand which failed to even consider the effects of Order No. 636. The absence of a connection between the rule itself and the data relied upon to calculate its benefits prompted the GAO to label the Commission's analysis as "questionable." In its view, the net benefits to be derived from Order No. 636 are not capable of being precisely quantified at this time. Nevertheless, the report noted, the final judgment will turn in large measure upon how small consumers' concerns are resolved. "These concerns include the effects of the new rate design, the extent of the transition costs (and the question of who will pay such costs) and the potential impact of the reliability of service, particularly service to distribution companies serving small communities." GENERAL ACCOUNTING OFFICE, *supra* note 87, at 13-14, 3-4.

which must be resolved before full deregulation can take hold. In a system of open access and unbundled service, the pipelines can only truly influence the behavior of the small customers. Yet, it is they who are the most vulnerable and the most incapable of bearing these transition costs.¹¹³ Unless more comprehensive steps are taken to ensure that these customers do not absorb the full impact of deregulation, the brave new world envisioned by Order No. 636 will be a bleak one for them indeed.¹¹⁴

It would seem to be in the best interests of the individual pipelines to work out final restructuring arrangements which do not unduly prejudice residential consumers. Unfortunately, the FERC has not provided any guidance for accomplishing this task. If, as consumer groups fear, the restructuring proceedings resemble dictations of terms more than bona fide negotiations, it is highly unlikely that the 636 transition will be completed with a minimum of fuss. Individual proceedings are bound to be contested and the final implementation of the restructuring rules will undoubtedly be delayed as they run the full gamut of administrative and judicial challenges. In what may be the greatest irony, the Commission's failure to adequately protect the small consumer in its issuance of Order No. 636, will probably result in an indefinite delay in its final implementation. This delay will actually prolong industry regulation, instead of hastening its demise.

113. Despite stating that it "is sympathetic to the concerns raised by small customers," the Commission did not offer much hope for optimism upon rehearing. "Should the small customers believe that the pipeline prices are not reasonable, because of the exercise of market power, they may seek appropriate relief from the Commission." Order No. 636-A, III F.E.R.C. Stats. & Regs. at 30,545.

114. It is interesting to note that in the proposed form of Order No. 636 there was an initial provision which excluded small customers from the unbundled sales requirement. To protect against large-scale market-based swings in gas prices, the Commission wished to permit them to continue receiving service on a bundled basis. See *FERC Majority Nearing Consensus on Most Aspects of Pipeline Industry Restructuring Rule*, FOSTER NAT. GAS REP., *supra* note 86, at 1.